PACIFIC ASSET MANAGEMENT

JUNE 2020

THE INVESTOR Compass

NAVIGATING THE CREDIT MARKETS

Investment Grade: Uncharted Waters

Entering 2020, the US markets were coming off a very strong 2019. Capital markets enjoyed the benefits of improving business sentiment, robust consumer demand and expectations for continued economic growth with limited inflation concerns. In particular, the investment grade bond universe (represented by the Blomberg Barclays US Aggregate Bond Index) returned nearly 14% in 2019, ending with a yield to worst of 2.79% and an OAS of 90bps. As COVID-19 concerns led to global economic shutdowns, liquidity quickly suffered as investors sold risk assets. By mid-March, the U.S. Credit Index had given back much of the gains from 2019, as yields and spreads widened significantly, resulting in a YTW of 4.07% and an OAS of 324bps.

The current landscape is dramatically different since the March lows. Since then, the S&P 500 is up over 40% and investment grade debt has rebounded an astonishing 14%. Yields are now just above 2.00%, with an OAS of 139bps. This unprecedented rally, which followed an equally unprecedented selloff, was triggered by immense monetary support via the Federal Reserve. Specifically, an announcement on March 23 by the Federal Reserve to establish a Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF) proved salient to the credit rebound. Despite the facilities not making purchases until late in the second quarter and not purchasing individual corporate bonds until mid-June, investment grade debt has experienced a ferocious rally. In addition to spreads and yields compressing, companies were able to secure significant liquidity at record low yields.

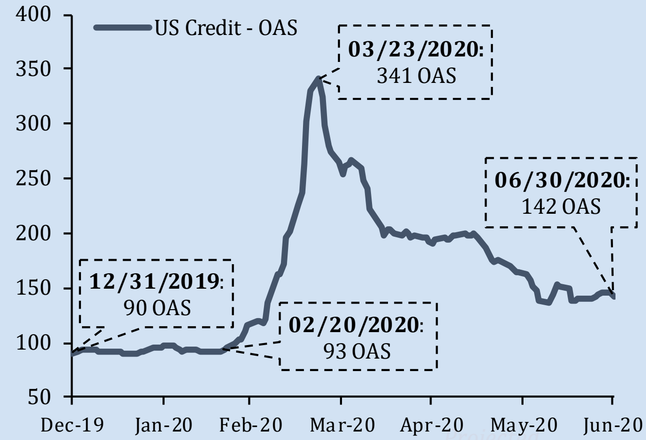
Table 1: Spread Moves of IG Issuers

IG Issuers	Rating	Prior	6/30/20
Procter & Gamble 10yr	(Aa3/AA-)	+225 on 3/23	+80
Coca-Cola 10yr	(A1/A+)	+255 on 3/20	+85
Intel 10yr	(A1/A+/A+)	+295 on 3/20	+83
Lowe's 10yr	(Baa1/BBB+)	+375 on 3/24	+130
Nike 10yr	(A1/AA-)	+200 on 3/25	+89
McDonald's 10yr	(Baa1/BBB+)	+285 on 3/25	+122
Walt Disney 10yr	(A2/A/A)	+270 on 3/19	+125
Pepsi 10yr	(A1/A+)	+180 on 3/17	+82

Source: Bloomberg, as of June 30, 2020

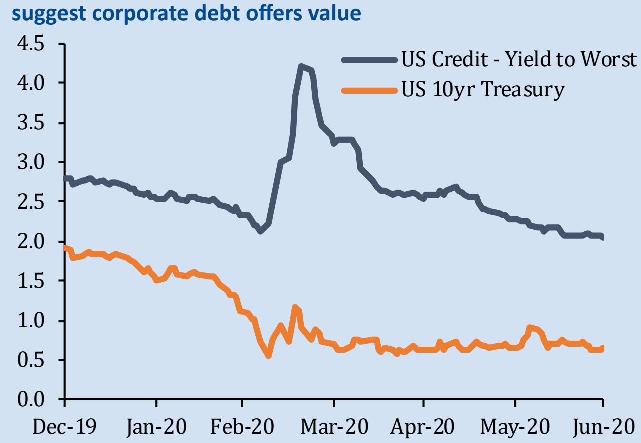
THE FED CURRENT

Spread moves have been violent thus far in 2020, with Fed support being the catalyst for reversal



Source: Bloomberg Barclays, as of June 30, 2020

Even with record low corporate yields, lower government yields suggest corporate debt offers value

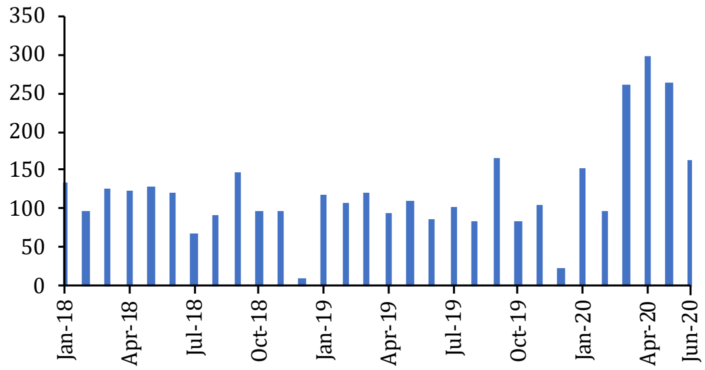


Source: Bloomberg Barclays, as of June 30, 2020

The Wave of Supply

The compression of corporate spreads and yields took place during the most robust period of investment grade new issuance in market history. Highly rated corporations have been able to issue debt at record pace, with many corporations raising capital multiple times during the quarter. US IG issuance reach $262bn in May (the second highest month on record) following $297bn in April (record setting month) resulting in YTD IG issuance exceeding 2019 IG issuance of $1.1tr.

Chart 1: IG Gross Supply ($bn)



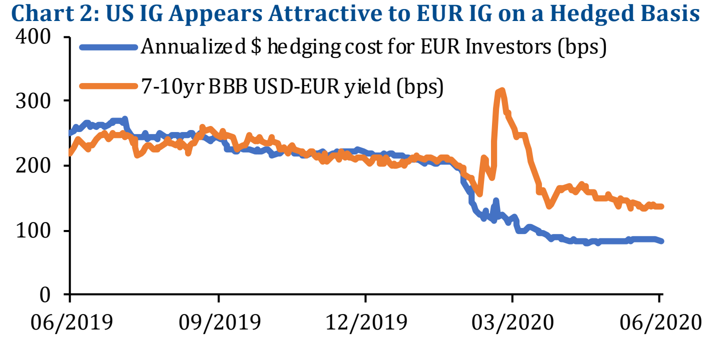
Source: Bloomberg, Bank of America Global Research as of June 30, 2020

In normal environments, excess issuance is cause for concern as spreads would likely widen as a reaction to increased leverage. However, debt issuance during this period has been viewed as ability to access liquidity and means to weather the "Great Shutdown." It is notable that a significant amount of issuance has been used as a vehicle to target out front-end debt in COVID impacted sectors (aircraft leasing, hotels, etc.) thereby creating a rather strong technical specific to the front-end of the credit curve. Given global sovereign yields, central bank support (even if just signalling), and preference for stronger companies, investor appetite has been robust enough to meet the elevated issuance. It is now likely most IG companies have amassed enough liquidity to weather the current economic strain. Thus, we expect issuance to slow substantially in 2H20. Most street estimates place total 2020 IG issuance between $1.4-$1.7tr. If this proves accurate, lower issuance should help reduce IG leverage levels. In addition, less issuance will help buoy further IG spread tightening as the year progresses.

Gyres

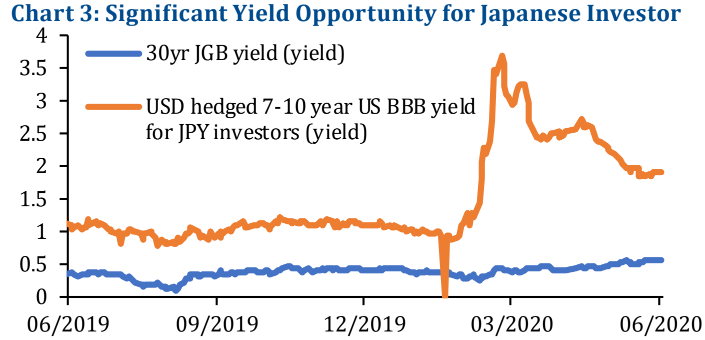
During the first two weeks of June, US IG bond funds and ETFs set record inflows of $14.88bn and $11.46bn, respectively. While it matters that yields are historically low, it matters more that spreads are a currently attractive at 139bps and offer the potential to tighten. The US IG buyer base was constructed of foreign investors, along with mutual funds/ETFs, who bought nearly 80% of net supply from 2010-2019 (per BAML). European/Asian investors are most concerned with corporate yields after accounting for dollar hedging costs, which thanks to reduced federal funds target rate, have collapsed, thereby making US IG more attractive.

Chart 2: US IG Appears Attractive to EUR IG on a Hedged Basis



Source: Bloomberg, as of June 30, 2020

Chart 3: Significant Yield Opportunity for Japanese Investor

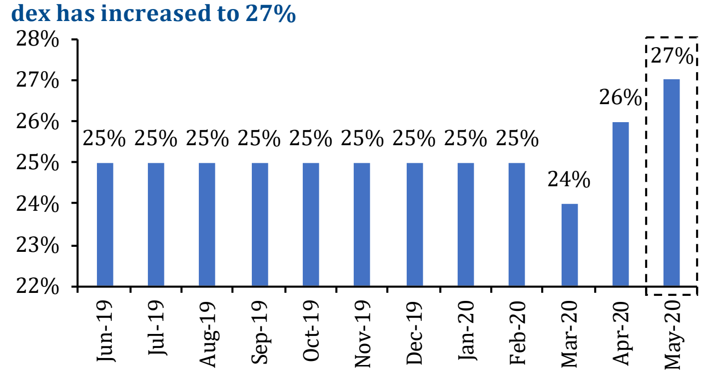


Source: Bloomberg as of as of June 30, 2020

Additionally, mutual fund/ETFs tend to be predominately purchased by retail investors seeking total return – which is supportive of spreads and inversely related to yield levels – further supporting additional purchases of the IG asset class.

According to JP Morgan, the Fed recently increasing its purchase of Treasuries is also supportive of IG flows and is changing the construct of the overall aggregate index.

Chart 4: Weighting of HG Corporates within the Aggregate Index has increased to 27%



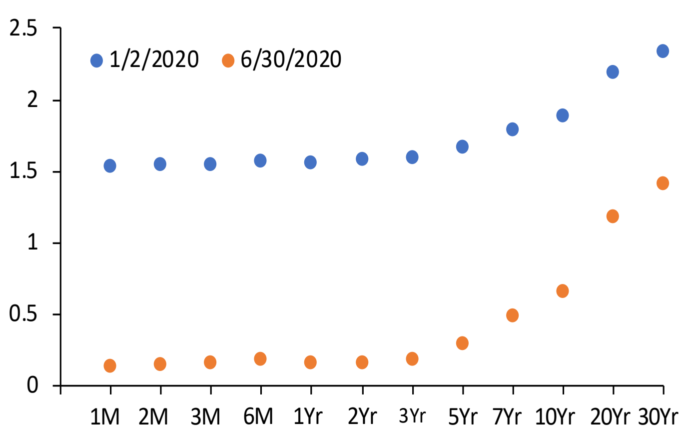
Source: JP Morgan, as of June 4, 2020

Interestingly, the increased Fed purchases have reduced the amount of Treasuries held within the Blomberg Barclays US Aggregate Bond Index and increased the amount of high grade corporates within the Index by 2.8% since March 2020 -the highest level since 1981. This is, by default, increasing passive Index benchmark investors' allocation to high grade corporates as the Index has morphed. By JP Morgan's estimate, this amounts to nearly $150bn of incremental demand from Index benchmarked mutual funds/ETFs over the last couple months.

Lifeboat

There is a strong case that can be made for the further advancement of markets given the multi-layers of support currently in place and those that can be put in place (via governments or central banks). Let's not forget the recently experienced impact that a massively supportive fiscal and monetary policy via stimulus packages and the Federal Reserve can create. Whether an investor philosophically agrees or not, the US government has proven it is willing and able to act as a lifeboat via four behemoth stimulus packages, small business support (PPP/grants/loans), tax friendly actions, and talk of subsequent stimulus provisions. The Federal Reserve has acted to stabilize a near sinking ship by reducing rates to zero, purchasing corporate bonds/IG ETFs via the Primary and Secondary Market Corporate Credit Facilities (and recently amending these facilities to broaden the scope of eligible bonds to purchase), as well as verbally committing to keeping rates near zero bound for the foreseeable future. Assuming tailwinds of fiscal and monetary action blow us in a prevailing positive direction - these actions are immensely supportive of credit spreads and the investment grade corporate bond asset class opportunity going forward.

Chart 5: Treasury Rates



Source: US Department of the Treasury as of June 30, 2020

With a significant base of liquidity and support to address downgrade and default risk of IG, spread compression could be enhanced further. A successful reopening of the economy would be a tidal wave of strength to support further spread compression of corporates. Additionally, the revelation of a COVID-19 vaccine or treatment would act to only enhance the reopening effect (not to mention reduce the tragic loss of life) and there is hope of treatments by year end or the beginning of 2021.

Charting the Course

As it relates to what lies ahead, the market is very similar to the sea as they can both be quite unpredictable. However, there are often markers that alert us. Future levels of rates and spreads will be affected by a variety of cross currents, which will inevitably determine broad total return. A strong economic reopening should reduce spreads, however, could result in higher base rates. A worse than expected second wave or flu season later this year would most likely reduce Treasury yields, resulting in higher credit spreads. However, it is apparent that public and private sectors, as well as global governments and central banks are banding together to bridge the gap to reach an end result of an eventual vaccine, full economic reopening, and return to normalcy. As we maneuver on this continuum, it is important to keep in mind things we feel are more likely than not, then adjust as new information reveals itself.

It also behooves us to remember that investment grade companies are rated as such because they are typically substantial companies that possess the ability to pivot and adapt to changing environments – these are corporations that can better weather the storm of uncertainty with greater confidence than their lower rated counterparts. However, corporate fundamentals remain under pressure resulting from downstream effects of the coronavirus impact. Investment grade downgrades were issued at record pace in 1H20, and although volume is expected to slow further in 2H20, caution should abound. Additionally, it is our view that accommodative fiscal and monetary policy are here for a significant duration. This is a major factor in support of lower rates AND lower spreads. Finally, we believe the economy will emerge resilient from the depths of the worst economic contraction in several generations.

Conclusion: Investment grade corporate bonds have numerous buoys to help it weather a challenging sea including low interest rates, central bank support, and fiscal stimulus. As it relates to fundamentals, the prospects of economic strength in two years is much higher than the prospects of economic strength six months from now (notable - we have spent the better part of a decade living with the exact opposite expectation). This favors larger corporations, as they can access liquidity with reduced leverage profiles, in the event economic growth stays muted longer than current expectations. For fixed income portfolios in need of an anchoring in investment grade debt, we believe U.S. corporate bonds offer an attractive risk-return profile.

Superseding the realm of investments - it is vitally important the focus remains on reducing the tragic loss of life, suffering, and heartbreak associated with this pandemic. The combined effort and sacrifice of the human race working together is instrumental to finding a cure and pressing on through this challenging time in history. Our sincerest appreciation and deepest gratitude to those frontline workers that place themselves in harm's way for the betterment of us all.

Pacific Asset Management
June 2020

ABOUT PACIFIC ASSET MANAGEMENT

Founded in 2007, Pacific Asset Management LLC, specializes in institutional fixed income management with a focus on corporate credit. The Firm definition changed on December 31, 2019. Prior to that date, the firm definition referred to Pacific Asset Management, a business division of Pacific Life Fund Advisors LLC ("PLFA"). As part of an internal restructuring initiative, the business division of PLFA, known as Pacific Asset Management, was reorganized into Pacific Asset Management LLC, an SEC registered investment adviser and an indirect wholly-owned subsidiary of Pacific Life Insurance Company (Pacific Life). As of May 30, 2020 Pacific Asset Management managed approximately $12.6bn.

IMPORTANT NOTES AND DISCLOSURES

Bank loan, corporate securities, and high yield bonds involve risk of default on interest and principal payments or price changes due to changes in credit quality of the borrower, among other risks.

This information is presented for informational purposes only. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole investment making decision. All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed. The opinions expressed herein are based on current market conditions and are subject to change without notice.

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